APPENDIX A.

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Decided May 13, 1969.)

Before: WEICK, Chief Judge, O'SULLIVAN and PHILLIPS, Circuit Judges.

O'SULLIVAN, Circuit Judge. Petitioners, Southeastern Canteen Co. and Canteen Service Co. of Toledo petition for our review of a decision of the Tax Court, entered September 19, 1967, upholding the Respondent-Commissioner's assessment of deficiencies in income tax in the amounts of $16,589.82 and $58,863.73, respectively. These deficiencies arose primarily from disallowance of parts of deductions from income taken by taxpayer corporations for rent and commissions paid by them to the then owner of the equipment used by taxpayers, and from disallowance of Southeastern Canteen Co.'s claim of corporate exemption from surtax on the first $25,000 of its earnings. Reason for these rulings was provided by a finding that the disallowed rent and commissions paid were not "ordinary and necessary expenses paid or incurred * * * in carrying on" the taxpayers' trade or business, within the meaning of the Internal Revenue Code of 1954, 26 U.S.C. § 162(a). Disallowance of the exemption from surtax of the first $25,000 of Southeastern Canteen Co. earnings, 26 U.S.C. § 11(d), was the product of the Tax Court's finding that Southeastern Canteen Co. was formed by the owners of Canteen Service Co. with the principal purpose of securing the surtax exemption of $25,000 of its earnings, contrary to Section 269 of the Internal Revenue Code of 1954, 26 U.S.C. § 269.

We agree with the Tax Court's affirmance of the Commissioner's disallowance of amounts claimed as rent and other business expenses. We reverse its holding which

denied Southeastern Canteen Co.'s use of the surtax exemption.

The Tax Court decision, filed September 19, 1967, is reported as *Southeastern Canteen Co. and Canteen Service Co. of Toledo v. Comm'r*, 36 P-H Tax Ct. Mem. 973, ¶ 67,183 (1967). The factual history is complicated. Buddies Box Lunch, Inc. was formed as an Ohio corporation on July 16, 1931. The outstanding capital stock was owned fifty percent by Virgil A. Gladieux and fifty percent by his brother, Nelson Gladieux. In 1955, Virgil became sole stockholder and in 1960 the corporate name was changed to Gladieux Corporation (hereinafter Gladco). Gladco was principally engaged in the operation of cafeterias and lunch counters and the dispensing of food in several manufacturing plants in Toledo, Ohio. It also sold candy, gum and nuts both at its lunch counters and through vending machines at locations in and near Toledo.

Canteen Service Co. of Toledo was incorporated as an Ohio corporation on March 16, 1946, and was principally engaged in the operation of vending machines in Lucas, Fulton and Wood counties in Northwestern Ohio under a franchise granted by Automatic Canteen Company of America (hereinafter Automatic). Its sole shareholder was Ben T. Handwork. On May 10, 1946, Gladco entered into an agreement with Canteen Service whereby Gladco transferred to Canteen Service its vending machine business in exchange for payment of location commissions on all gross sales of candy, gum and nuts sold through vending machines previously operated by Gladco and at all locations where Gladco then operated food dispensing facilities. Gladco, pursuant to an option in the agreement, purchased seventy-five percent of Canteen Service's stock on or before October 31, 1946. Later, as a result of redemption of Handwork's remaining twenty-five percent

stock interest, Gladco became the sole owner of Canteen Service.

Southeastern Canteen Co. was incorporated as a Michigan corporation on January 19, 1956. Its business was the same as Canteen Service's—the sale of food and beverages through vending machines under a franchise granted by Automatic—but the territory of the business was Lenawee and Monroe counties in southeastern Michigan. Southeastern issued twenty shares of stock—fifteen to Virgil Gladieux and five to Ben Handwork. In 1959, Southeastern redeemed Handwork's stock, with Gladieux thereby becoming sole stockholder.

Thus, by 1960 Canteen Service Co., an Ohio corporation, was wholly owned by the Gladieux Corporation (Gladco) and the corporate shares of Gladco and Southeastern, the Michigan corporation, were wholly owned by Virgil T. Gladieux. Virgil and his wife, Beatrice G. Gladieux, were also the sole shareholders in twelve other corporations engaged in the merchandising and vending of food, beverages and gum in various areas of the United States. On June 30, 1960, Virgil and his wife agreed to transfer all fifteen corporations to ABC Vending Corporation, a large publicly owned Delaware corporation, in exchange for 80,000 shares of its stock, an option to purchase 5,000 additional shares, and an executive position with ABC at an annual salary of $62,500.[1] The franchise agreements which Canteen Service and Southeastern had with Automatic, however, gave Automatic a right to withhold consent to a transfer of Canteen Service or Southeastern.[2] Automatic exercised this right and refused to permit the transfer of either company to ABC. Virgil

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[1] ABC, at the time, had 8,522 shareholders owning 1,228,328 shares of common stock included 48,960 treasury shares.

[2] Article V, Section 25 of Franchise Agreement.

Gladieux's arrangement to circumvent this refusal brought about most of the litigation before us.

Prevented from total performance of the June 30, 1960 agreement, Virgil, on January 26, 1961, by "Supplemental Agreement" transferred to ABC his other thirteen corporations, including Gladco, in exchange for 68,500 shares of stock, the stock option, and the executive position with ABC.[3] There were also negotiated, as of January 31, 1961, agreements between Gladco (then owned by ABC) and Canteen Service (controlled by Virgil Gladieux), and between Gladco and Southeastern (still controlled by Virgil). The terms of these latter agreements were substantially as follows: Canteen Service and Southeastern (petitioners) would transfer to Gladco their tangible physical assets at a price determined by their net book value as of October 1, 1960. Gladco would then lease back to petitioners all such assets for a term of twenty years, beginning October 1, 1960, and would lease to petitioners "all additional equipment necessary for the operation of the vending machine business." Petitioners would pay to Gladco for such leased assets a "rental" equal to ten percent of their gross sales attributable to the vending machine business during the term of the lease, provided such "rental" did not create a deficit in the net income of either petitioner. Petitioners would pay increased "fixed location commissions" to Gladco with respect to all sales at vending machine locations derived through Gladco, Virgil or any affiliated corporations. In consideration for the transfer of their physical assets, Gladco paid to Canteen Service and Southeastern

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[3] The six-month delay in negotiations was caused by the fact that Automatic's refusal to consent was submitted to arbitration, and the arbitrator's decision (in Automatic's favor) was not rendered until December 27, 1960.

$184,659.85 and $5,109.43, respectively. All of this money was used along with $201,827.30 and $52,863.64, respectively, out of their other funds, to purchase 11,500 shares of ABC stock in the spring of 1961. By this purchase, Virgil then held, directly or indirectly, the 80,000 shares of stock he would have acquired had the original agreement not been blocked by Automatic.

The Commissioner made the following deficiency assessments: against Canteen Service Co. of Toledo and Southeastern, together, $58,863.71 for the tax year ending September 30, 1961;[4] against Southeastern Canteen Co. (the Michigan Corporation), $4,936.82, $5,458.89 and $6,194.61 for the tax years ending October 3, 1959, October 1, 1960, and September 30, 1961, respectively.[5]

We consider then, 1) disallowance of rental payments made by petitioners to Gladco, 2) disallowance of location commissions paid by petitioners to Gladco, and 3) disallowance of surtax exemption claimed by Southeastern.

1) Purported Rental Payments.

For their fiscal year ending September 30, 1961, petitioners Canteen Service and Southeastern claimed deductions of $121,172.15 and $12,211.30, respectively, for amounts paid as rent to Gladco pursuant to the sale-leaseback agreement of January 31, 1961. These deductions were claimed under Section 162(a)(3) of the Internal Revenue Code of 1954, 26 U.S.C. § 162(a)(3), which reads in pertinent part as follows:

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[4] This amount represents the disallowance of a portion of the rental and location commission deductions taken by Canteen Service and Southeastern.

[5] These were the consequence of disallowing Southeastern's surtax exemption for the mentioned years.

"(a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The Commissioner, however, disallowed petitioners' claimed deductions to the extent that they exceeded $53,592.79 and $1,906.59, respectively. He based his determination on the conclusions that the sale-leaseback agreement was not negotiated at arm's length between adverse parties and that the claimed rentals did not represent the fair rental value of the assets leased. The fact that the parties designated, and one party became obligated to pay to the other, a specified amount as rent does not bind the government to treat that amount as rent. *Catherine G. Armston,* 12 T.C. 539, 548 (1949), *aff'd sub nom. W. H. Armston Co., Inc. v. Comm'r,* 188 F(2) 531, 533 (5th Cir. 1951). Where there is an absence of arm's length dealing, the Commissioner may inquire into what constitutes reasonable rental to determine whether the amount paid exceeds what would have been paid had the parties dealt at arm's length. *Roland P. Place,* 17 T.C. 199, 203 (1951), *affirmed,* 199 F(2) 373 (6th Cir. 1952), *cert. denied,* 344 U.S. 927 (1953). See also, *J. J. Kirk, Inc.,* 34 T.C. 130 (1960), *affirmed* 289 F(2) 935 (6th Cir. 1961).[6]

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[6] This power given the Commissioner is but a corollary to the broader proposition that the substance of a transaction rather than the form is controlling. *Gregory v. Helvering,* 293 U.S. 465, 79 L.Ed. 596 (1935); *Smith v. Comm'r,* 370 F(2) 178 (6th Cir. 1966).

The issue is whether the involved parties negotiated the sale-leaseback agreement at arm's length. This is an issue of fact, and the Tax Court's findings can be reversed only if found to be clearly erroneous. *Comm'r v. Duberstein*, 363 U.S. 278, 291 (1960). We consider that the Court's findings are not clearly erroneous, and agree with the following from the Tax Court's decision:

> "The dominant motives of both Virgil and ABC throughout the negotiations which culminated in the sale-leaseback agreements are crystal clear. Virgil sought to obtain ABC stock and an executive position with the company and ABC sought to acquire Virgil's 15 food service companies. In light of these facts, we think it abundantly clear that the sale-leaseback agreements were designed solely to fulfill the personal objectives of Virgil. There was no legitimate business purpose for petitioners to undertake the sale and subsequent leaseback of their tangible assets other than to satisfy Virgil's purpose of shifting income from petitioners to Gladco in order to induce ABC to go through with the deal. Thus, this is not a case where a corporation entered a sale-leaseback arrangement in order to generate needed cash for business expansion. To the contrary, all the money received by petitioners upon the sale of their tangible assets, together with substantial additional amounts, was used to purchase ABC stock, thus serving no meaningful business purpose to petitioners.
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> "Petitioners' position is further weakened by the fact that during the entire negotiations leading up to the execution of the sale-leaseback agreements, the owner of both the lessor (Gladco) and the lessees (petitioners) was the same person, Virgil Gladieux. Petitioners' attempt to transform such an identity of interest into a relationship which petitioners characterize as adverse, transgresses reasonable imagination. All the more so since the facts show that

> the sale-leaseback agreements were not intended to be ends in themselves but merely steps in an integrated plan to secure to Virgil and ABC advantages which could not benefit petitioners in any meaningful way. From a review of all the facts bearing on this issue, which have been set out at length in our findings, we are convinced that the sale-leaseback agreements in question were not the result of arm's length negotiation between adverse parties and, therefore, we must determine whether the purported rentals were 'in excess of what the lessee[s] would have been required to pay had * * * [they] dealt at arm's length with a stranger.' *Roland P. Place, supra.*"

An important consideration is that Virgil Gladieux was, on the one hand, sole stockholder of the petitioners and, on the other, a stockholder and executive of ABC. It was not essential to him that he profit in his capacity *as owner of the petitioners*, but only that he profit in the sale-leaseback transaction *as a whole.*

Petitioners do not squarely raise the contention that, whether or not the involved negotiations and dealings were at arm's length, the rental payments were reasonable. We are not compelled to reach this question but the following, brought to our attention by the government's brief, persuades us that the Tax Court's determination of deficiency was not clearly erroneous:

> "Taxpayers argue that the rentals paid were reasonable in light of the fact that the lessor (Gladco) furnished them with additional equipment for their use. However, even taking this fact into consideration, the record shows that the glaring disparity is still present. For the period October 1, 1960, through October 3, 1964, taxpayer, Southeastern, paid the lessor (Gladco) total rentals of $62,487.98, receiving on the other hand for the period October 1, 1960, through December 27, 1964, additional equipment

costing Gladco $12,097.91. For the same periods Canteen Service paid Gladco total rentals of $432,835.18, receiving from Gladco additional equipment costing the latter $595,591.12. Thus, Southeastern paid Gladco $62,487.98 to lease equipment valued by the parties at $17,207.34 ($5,109.43 sales price plus $12,097.91) and Canteen Service paid Gladco $432,835.18 to lease equipment valued by the parties at $780,250.97 ($184,659.85 sales price plus $595,591.12). Moreover, an even greater disparity existed for the period October 1, 1960, through December, 1962 with respect to assets costing Gladco a total of $251,197.03 which were rented to Canteen Service for $208,176.58 as of September 29, 1962."

2) Location Commissions.

In 1946, subsequent to Canteen Service's incorporation, it entered into an agreement with Gladco (then named Buddies Lunch System, Inc) whereby Gladco transferred to Canteen Service its vending machine business in exchange for payment of location commissions on sales of candy, gum and nuts sold through vending machines previously operated by Gladco or at locations where Gladco then operated food dispensing facilities. At the time, Canteen Service was wholly-owned by Ben Handwork, and Gladco by Virgil and Nelson Gladieux. This 1946 agreement was continued and substantially modified and extended by the January 31, 1961 agreement between Canteen Service (then controlled by Virgil) and Gladco (then owned by ABC). An agreement of the same date between Southeastern and Gladco established location commissions payable from Southeastern to Gladco, although there is no evidence of a previous agreement between these parties.

In their fiscal year 1961, Canteen Service and Southeastern paid or accrued to Gladco location commissions

of $134,920.68 and $9,174.57, respectively. In their corporate income tax returns for that year, they deducted those amounts as "ordinary and necessary expenses paid or incurred * * * in carrying on any trade or business," under Section 162(a) of the Internal Revenue Code of 1954, 26 U.S.C. § 162(a).

Of these amounts, the Commissioner disallowed $74,088.26 and $1,593.84, respectively. $69,429.16 of Canteen Service's disallowance was attributable to the entire location commissions at two large corporations, LOF Glass (Libbey-Owens-Ford) and Toledo Scale. The remaining amount disallowed to Canteen—$4,659.10—and the full amount disallowed to Southeastern constituted excess location commissions computed under the higher rates determined in the January 31, 1961 agreement but applicable retroactively, beginning October 1, 1960, at a time when the 1946 agreement was still in effect.

The Commissioner found, and the Tax Court affirmed, that the disallowed portions of the location commissions were not "ordinary and necessary" business expenses, nor were they "appropriate and helpful" to petitioners' business. See *Comm'r v. Tellier*, 383 U.S. 687, 689 (1966). With regard to the location commissions at LOF Glass and Toledo Scale, the Tax Court stated:

> "[P]rior to the 1961 agreement, imposing increased location commissions on petitioners retroactively to October 1, 1960, Gladco had waived all commission payments due from Canteen Service on the LOF Glass and Toledo Scale business. The waivers as to those commission payments occurred at the time Canteen Service began making location commission payments directly to the industrial clients, LOF Glass and Toledo Scale. Thus, for several years prior to the 1961 agreement, Canteen Service was not required to make any location commission payments to Gladco

on its LOF Glass and Toledo Scale business. However, in order for Virgil's deal with ABC to be consummated, it became necessary to shift all income of petitioners to Gladco. To accomplish this objective Canteen Service was required to reinstitute location commission payments to Gladco on its LOF Glass and Toledo Scale business, which was, of course, in addition to the amounts Canteen Service was required to pay Gladco as purported rental payments. We can find no reasonable explanation for reinstituting such location commissions except as a further device to accomplish the shifting of all petitioners' income to Gladco. The record specifically shows that at the time Virgil was negotiating with representatives of ABC, he felt ABC was intending to acquire, by the various agreements, all the operating income of petitioners.

"Even more objectionable to allowing Canteen Service's location commissions in question is the fact that not only prior to, but for the year in question, Canteen Service paid location commissions directly to LOF Glass and Toledo Scale for the right to operate vending machines on the premises of those industrial customers. In 1961, Canteen Service paid to those customers the combined amount of $12,401.70 in location commissions. In spite of this, petitioners contend that they are entitled to deduct the further amount of $69,429.16 paid to Gladco as location commissions for vending machine sales on the premises of the same two customers. The record fails to reflect any business or economic need for Canteen Service to make the location commission payments in question, and in light of the fact that Canteen Service was already making payments directly to LOF Glass and Toledo Scale, we know of none. Lacking in any meaningful business purpose we fail to see how the payment of such obviously unnecessary amounts could be 'appropriate and helpful' for the development of Canteen Service's business."

With regard to the additional, retroactive commissions, the Court found that the Commissioner had disallowed only that amount which,

> "exceeded the commissions computed pursuant to the rates in effect under the agreement between Canteen Service and Gladco, dated May 16, 1946. Thus, for the period October 1, 1960, through February 20, 1961, respondent disallowed only $4,659.10 out of $25,999.22 claimed by Canteen Service and disallowed $1,593.84 out of $3,558.36 claimed by Southeastern. Since respondent has allowed petitioners' claimed location commissions, although at the lower rates in effect prior to the 1961 agreements, the only question presented is whether respondent correctly disallowed the retroactive increases required by the 1961 agreements.
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> "Petitioners contend that the location commissions were made retroactive to October 1, 1960, because that was the date, originally contemplated by ABC and Virgil in their agreement of June 30, 1960, when the exchange of Virgil's 15 companies was to be made in return for ABC stock. This fact is apparently relied upon by petitioners to justify making the commission payments retroactive to October 1, 1960. Even conceding that the October 1 date was set for that purpose, which the record does not necessarily support, we think petitioners' position is irrelevant with regard to the payment of location commissions by Canteen Service and Southeastern inasmuch as the limited question for our determination is whether the retroactive payments constituted ordinary and necessary business expenses to petitioners. Thus, while the October 1 date may have been required in order for Virgil to consummate his deal with ABC, we find no valid business reason in the record for petitioners to retroactively pay increased location commissions for more than 4 months. The record is devoid of any meaningful economic benefit flowing to petitioners for such

payments, and consistent with our prior determination, *supra*, we think the retroactively increased rates imposed upon petitioners under their 1961 agreements with Gladco merely constituted a necessary concession on Virgil's part, in order to consummate his personal deal with ABC, irrespective of whether such a result proved 'appropriate and helpful' for the development of petitioners' business."

The question of whether these claimed deductions come within Section 162(a) is a factual determination. *Comm'r v. Heininger*, 320 U.S. 467, 475, 88 L.Ed. 171, 177 (1943). It is thus reversible only if clearly erroneous. *Comm'r v. Duberstein, supra*. We are of the opinion that the Tax Court's findings and conclusions in this regard are not clearly erroneous.

Petitioners' principal argument is that the location commissions were adopted by the 1946 agreement negotiated at arm's length between Canteen Service and Gladco which were, at that time, owned by separate, unrelated parties. The 1946 agreement covered only commissions on candy, gum and nuts. The 1961 agreements encompassed commissions on seven additional items: coffee, pastry, milk, ice cream, sandwiches, hot foods, and cigarettes. The 1946 agreement was not merely "supplemented" by the 1961 agreement, as petitioners argue, but was broadened and extended manyfold. It cannot be considered an erroneous finding that the disallowed location commissions were derived from the 1961 agreements, and failed to serve an excludable business purpose.

3) Denial of Surtax Exemption.

In 1956 Southeastern Canteen Co. was organized as a Michigan corporation by Virgil Gladieux and Ben T. Handwork, who then were the owners of Canteen Service Co. of

Toledo. Later Virgil Gladieux became its sole shareholder. Section 11 of the Internal Revenue Code of 1954, 26 U.S.C. § 11, imposes a tax on the taxable income of corporations consisting of a normal tax and a surtax. Under Section 11(d), the surtax is not imposed upon the first $25,000 of a corporation's taxable income. Both Canteen Service and Southeastern had claimed his $25,000 surtax exemption each year. The Commissioner, however, determined that Southeastern—which engaged in the same business as Canteen but in two Southeastern Michigan counties while Canteen operated in Northwest Ohio—was not entitled to the surtax exemption for its fiscal years ending October 3, 1959, October 1, 1960, and September 30, 1961, on the authority of Section 269(a) of the Code, 26 U.S.C. § 269 (a), which reads in pertinent part:

"In general—if—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation,

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and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2) control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation."

Specifically, the Commissioner found that Virgil Gladieux and Ben Handwork, sole stockholders in Canteen Service, in 1956 formed or "acquired" Southeastern, of which they

became sole stockholders, for the principal purpose of gaining a second $25,000 surtax exemption.

The Tax Court affirmed this determination, stating, "Upon a consideration of the entire record, we think the facts require us to hold that Southeastern was incorporated in 1956 for the principal purpose of avoiding Federal income taxes * * *."

The issue, then, is whether the "principal purpose" of Southeastern's acquisition was "avoidance of Federal income tax." "Principal purpose" is further defined by Treasury Regulations, Section 1.269-3(a), 26 C.F.R. § 1.269-3(a), as follows:

> "If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of Section 269 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom."

This issue involves a factual determination which can be reversed only if found to be clearly erroneous. *Comm'r v. Duberstein*, 363 U.S. 278 (1960). The Commissioner's disallowance of the surtax exemption is presumptively correct, and the burden of disproving such determination by a preponderance of the evidence is on petitioners. 26 C.F.R. § 1.269-5; *Welch v. Helvering*, 290 U.S. 111, 115, 78 L.Ed. 212, 215 (1933); *Helvering v. Taylor*, 293 U.S. 507, 515, 79 L.Ed. 623, 629 (1935).

We believe, however, that petitioners met their burden of proving by a preponderance of the evidence that the

principal purpose of forming Southeastern was not tax avoidance. At trial before the Tax Court, the sole witness to testify on this issue was Virgil Gladieux, controlling stockholder of both Canteen Service and Southeastern at the time in question. Gladieux testified that no consideration to Federal income tax law was given at the time of Southeastern's incorporation,[7] and that the reason for a separate corporation was that "we needed identity, local identity, and we needed a Michigan image." Respondent urges that neither this Court nor the Tax Court is bound to accept the testimony of Gladieux, an interested party, even though not contradicted, citing *Quock Ting v. United States*, 140 U.S. 417 (1891). But this is not to say that clear, convincing and uncontradicted testimony can be ignored just because of the interest of the witness. The correct rule is recited in *Quock Ting*:

> "Undoubtedly, as a general rule, positive testimony as to a particular fact, uncontradicted by any one, should control the decision of the court; but that rule admits of many exceptions. There may be such an inherent improbability in the statements of a witness as to induce the court or jury to disregard his evidence, even in the absence of any direct conflicting testimony." 140 U.S. at 420.

Gladieux's testimony went unchallenged by the government. This Court has held that "where unimpeached, competent, and relevant testimony on behalf of a taxpayer is uncontradicted, it may not be arbitrarily discredited and disregarded, and the Tax Court cannot reject or ignore this evidence * * *." *Loesch & Green Const. Co. v. Comm'r*, 211 F(2) 210, 212 (6th Cir. 1954). See also, *Tank v. Comm'r*, 270 F(2) 477, 487 (6th Cir. 1959). The

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[7] The attorney employed by Gladieux in incorporating Southeastern, a Mr. Smith, was deceased at the time of hearing.

Treasury Regulations indicate that "a scrutiny of the entire circumstances" surrounding the acquisition must be made. 26 C.F.R. § 1.269-3(a). Obeying such Regulations, we are persuaded that a review of the "entire circumstances" substantiates Gladieux's testimony. Southeastern was given a separate "Michigan image" by Gladieux. Books and records of Canteen Service and Southeastern were kept separate and distinct. There were separate warehouses and bank accounts in Michigan. None of Canteen's inventory was used in Southeastern's operations. Southeastern's two resident managers were based in Adrian and Monroe, Michigan—the county seats of the two Michigan counties Southeastern serviced—rather than in Toledo where Canteen's headquarters was located. Virgil Gladieux had established a tradition of incorporating a new company whenever he initiated a new, albeit related, enterprise. In 1961 he controlled a total of fifteen corporations, all engaged in the food distribution business. For example, *Ohio* corporations, controlled by Gladieux, operated in-plant feeding at corporations in *Ohio* whose vending machines were serviced by Canteen Service, but in-plant feeding at the Revco Corporation plant in Deerfield, *Michigan*—in the vending machine territory of Southeastern—was performed by Buddies Lunch System, a Gladieux-controlled *Michigan* corporation.

The Tax Court sought to tarnish Gladieux's "Michigan image" argument by noting that "the franchise agreement under which Southeastern obtained virtually all its vending machines, specifically prohibited Southeastern from using its name on the vending machines in a manner which would give the appearance that Southeastern was the *owner* of the machines." (Emphasis supplied.) The franchise agreement, however, permitted Southeastern to advertise on the machines that it was *servicing* them.

In this way, Southeastern was able to effectively present a "Michigan image" to the public.

A recent Court of Claims case parallels the instant case in some respects. In *Louisville Store of Liberty, Ky., Inc. v. United States*, 179 Ct. Cl. 847, 376 F (2) 314 (1967), a partnership consisting of five related partners owned thirteen clothing stores in nine Kentucky towns. In 1959, the partners incorporated eleven of the stores in eleven separate corporations. The Commissioner, relying on Section 269, allowed but one surtax exemption to the entire group of corporations. The Court of Claims, adopting the opinion of Court Commissioner Day, determined that the purpose of incorporation of the companies was not principally to avoid tax within the meaning of Section 269, and held that each company was entitled to the benefit of the $25,000 surtax exemption. The Commissioner's opinion agreed with the United States Senate Finance Committee that, where *corporations controlled by the same persons engage in the same type business in different geographic locations*, there are legitimate business reasons for establishing separate corporations.

> "Congress, in considering the Revenue Act of 1964, reviewed the application of the provisions of section 269, concluding that there were indeed legitimate business reasons in the use of multiple corporations where corporations owned or controlled by the same interests, as here, conduct the same type of business in different geographical locales, as here. The Senate Finance Committee made the following comment in this connection:
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> " 'While the House and your committee recognize the advantages of use of multiple corporations, it is believed, as it has been in the past, that, where corporations owned and controlled by the same interests

engage in different businesses in the same area or conduct the same type business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions. However, the House and your committee do not intend to encourage the formation of these multiple corporations and therefore propose to apply higher tax rates to corporations which are members of an affiliated group of corporations. Of course, nothing in this bill is intended as changing the application of sections 269, 1551, or 482 if the multiple corporation form of organization is adopted to avoid taxes.'

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"Sen. Rep. 830, 88th Cong. 2d Sess., pp. 149-150, Cum. Bull. 1964-1 (Part 2) pp. 653-654.

"The House Ways and Means Committee adopted similar language in its report on the same subject. See H.R. Rep. No. 749, 88th Cong. 1st Sess. Cum. Bull. 1964-1 (Part 2) p. 242." 376 F(2) at 319.

Such, in substance, were the holdings in *Bush Hog Mfg. Co.*, 42 T.C. 713, 726-729 (1964), and *V. H. Monette & Co.*, 45 T.C. 15, 33-35 (1965), *aff'd on other grounds*, 374 F(2) 116 (4th Cir. 1967).

We hold that, under the circumstances where the controlling stockholder of both the parent and acquired corporation testified that the reason for creating a separate corporation to engage in the same business in a different geographic location was to present a local image and was not tax avoidance, where the testimony was uncontroverted and unimpeached, and where there was substantial evidence to corroborate his testimony regarding the presentation of the local image, it was improper for the Commissioner to deny the acquired corporation its

$25,000 surtax exemption. To the extent that this holding may be factually inconsistent with the Tax Court's findings of fact, we hold, obedient to *Comm'r v. Duberstein, supra,* that its findings are clearly erroneous.

The judgment of the Tax Court sustained the Commissioner's disallowance of rental and location commission payments is affirmed; the judgment of the Tax Court sustaining the Commissioner's disallowance of the surtax exemption as to Southeastern Canteen Co. is reversed and vacated. Each party shall pay its own costs.

APPENDIX B.

MEMORANDUM FINDINGS OF FACT AND OPINION OF THE UNITED STATES TAX COURT.

(Filed September 19, 1967.)

WITHEY, *Judge*: Respondent determined deficiencies in petitioners' income tax for the years and in the amounts as follows:

Petitioner	Docket No.	Taxable year ended	Deficiency
Southeastern Canteen Co.	4301-64	Oct. 3, 1959	$ 4,936.32
		Oct. 1, 1960	5,458.89
Canteen Service Co. of Toledo	4302-64	Sept. 30, 1961	6,194.61
		Sept. 30, 1961	58,863.73

The cases have been consolidated and will be decided together.

The issues for decision are:

(1) Whether the purported rentals paid or accrued in favor of the Gladieux Corporation by petitioners for their fiscal year ended September 30, 1961, constitute allowable deductions from their respective gross incomes in that year, pursuant to section 162(a)(3) of the Internal Revenue Code of 1954.[1]

(2) Whether the location commissions paid or accrued in favor of the Gladieux Corporation by petitioners for their fiscal year ended September 30, 1961, constitute allowable deductions from their respective gross incomes in that year, pursuant to section 162(a) of the Code.

(3) Whether respondent properly disallowed Southeastern Canteen Co. a statutory surtax exemption for its fiscal years ended October 3, 1959, October 1, 1960, and September 30, 1961, pursuant to section 269 or 1551 of the Code.

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[1] All statutory references hereinafter are to the Internal Revenue Code of 1954.

FINDINGS OF FACT.

Some of the facts have been stipulated and are found accordingly.

Petitioner Canteen Service Co. of Toledo (hereinafter called Canteen Service) is, and at at all times pertinent hereto was, a corporation incorporated March 16, 1946, under the laws of the State of Ohio with its principal office in Toledo, Ohio. For the tax year ended September 30, 1961, Canteen Service filed its corporate income tax return with the district director at Cleveland, Ohio, listing its corporate address as 3156 Bellevue Road, Toledo 6, Ohio.

Petitioner Southeastern Canteen Co. (hereinafter Southeastern) is, and at all times pertinent hereto was, a corporation incorporated under the laws of the State of Michigan on January 19, 1956. Its registered office was in Detroit, Michigan, and its corporate officers were housed in Toledo, Ohio. For the tax years ended October 3, 1959, October 1, 1960, and September 30, 1961, Southeastern filed its corporate income tax returns with the district director at Cleveland, Ohio, listing its corporate address as 3156 Bellevue Road, Toledo 6, Ohio.

At the time Canteen Service was incorporated, its entire capital common stock was issued to Ben T. Handwork (hereinafter Handwork) in exchange, among other things, for the use by Canteen Service of a franchise previously granted to Handwork by Automatic Canteen Company of America (hereinafter sometimes Automatic) for the sale of candy, gum, nuts, and related items through vending machines. In early 1953, Canteen Service, with the oral permission of Automatic, began operating eight canteen locations at the Revco Manufacturing Co. in Deerfield, Lenawee County, Michigan. On May 15, 1956, Canteen Service filed a notice of withdrawal with

the Michigan Corporation and Securities Commisssion and, subsequent to that date, no longer conducted business in Michigan.

During the tax year involving Canteen Service, 1961, its books and records were maintained under the accrual system of accounting and the 13-period system of tabulating its income and expenses was employed, each such period consisting of 4 weeks. During that year, Canteen Service sold food and beverages through vending machines in certain territories in western Ohio, such territories being among those originally designated in a franchise and distributor's lease agreement entered into between Automatic and Handwork on July 6, 1947, and assigned to Canteen Service on that day by Handwork with the consent of Automatic. Under this franchise and lease agreement, Canteen Service leased canteens[2] from Automatic in its fiscal year 1961, in numbers varying from 1,627 to 1,676, and reported to Automatic gross sales from those canteens of $1,318,901. Canteen Service reported on its tax return for fiscal 1961, gross sales of $1,651,490.29.[3]

Upon the incorporation of Southeastern in 1956, its authorized capital stock consisted of 1,000 common shares of the par value of $50. Of that amount, Virgil Gladieux (hereinafter sometimes referred to as Virgil) and Handwork subscribed for 15 shares and 5 shares, respectively. On July 21, 1959, Southeastern redeemed the 5 shares owned by Handwork which redemption resulted in Virgil's becoming the owner of Southeastern's entire outstanding common stock.

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[2] Under the franchise and lease agreement, a "Canteen" was defined as a candy, gum, nut, or other vending machine, although that word will sometimes be used hereinafter to designate more than one such machine at a given location.

[3] The additional revenue reported on its tax return was attributable to vending machines owned outright by Canteen Service.

During the tax years involving Southeastern, its books were maintained under the accrual system of accounting and the 13-period system of tabulating its income and expenses was employed, each such period consisting of 4 weeks. During those years, Southeastern had the exclusive rights to the sale of food and beverages through vending machines in Lenawee and Monroe Counties in southeastern Michigan, such counties being among those originally designated in a franchise and distributor's lease agreement entered into between Automatic and Handwork on January 20, 1956, and assigned to Southeastern on that day by Handwork with the consent of Automatic. Under this franchise and lease agreement, Southeastern leased canteens from Automatic in its fiscal year 1961, in numbers varying from 252 to 273, and reported to Automatic gross sales from these canteens of $185,469.

Southeastern's franchise from Automatic provided not only for exclusive territory but also for the leasing of canteens from Automatic to Southeastern for rent. It also provided that Southeastern was to periodically deliver to Automatic a report of the canteen sales, from which such rentals were determined. It provided further that title to the rented canteens was to remain in Automatic, that Southeastern was prohibited from attaching its name to the canteens except to show that it was servicing such equipment, that the franchise could be canceled under certain circumstances, and that a sum of $50 would be payable by Southeastern to Automatic, as liquidated damages, for each canteen if either the franchise was canceled or if there was any interference by Southeastern with the continued ownership and use of such canteen location by Automatic. The franchise further provided that if Handwork disposed of, or attempted to dispose of the franchise by sale, assignment, transfer, rent, or sub-

lease, without the prior consent of Automatic, the franchise agreement was to be null and void.

Southeastern commenced business on January 21, 1956, starting its route operations with vending machines, inventory, and trucks. As of that date, Southeastern's capital was $1,000. On January 23, 1956, Southeastern's directors, at their first board meeting, adopted resolutions, among other things, to purchase vending machines from Automatic and to open an account at a bank in Monroe, Michigan. Southeastern employed a resident of each of those counties to supervise the company's operations. Thus, at its inception, Southeastern's operations were conducted from the Michigan residences of those two employees. Later, Southeastern established warehouse and refrigeration facilities in Monroe County, Michigan. Although Southeastern acquired certain operating assets and leased vending machines from Automatic, as provided in its franchise agreement, Automatic had no stock interest in Southeastern.

Prior to May 10, 1946, the Gladieux Corporation (hereinafter Gladco)[4] was principally engaged in the business of operating cafeterias and lunch counters, and dispensing food in several manufacturing plants in the city of Toledo and vicinity. It also sold candy, gum, and nuts both over its counters and through vending machines at such food locations, at gas stations, and other locations. Gladco's books and records were maintained on the accrual system of accounting and on a calendar year basis.

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[4] Gladieux Corporation's predecessor business was incorporated in 1931 under the name of Buddies Box Lunch, Inc. It was only after three corporate name changes that the name of the business became Gladieux Corporation on November 2, 1960. To avoid confusion, use of the name Gladco will be used to refer to the same business, both before and after its name became Gladieux Corporation.

As of May 10, 1946, Gladco's outstanding capital stock was owned equally by Virgil Gladieux and his brother Nelson. On May 25, 1955, Virgil became the sole stockholder of Gladco.

On May 10, 1946, an agreement was entered into between Gladco and the Gladieux brothers, on the one hand, and Canteen Service and Handwork, on the other. Pursuant to the agreement, Gladco transferred its vending machine business in Lucas, Fulton, and Wood Counties, Ohio, to Canteen Service. The agreement provided, in part, that Canteen Service would pay Gladco a 12 percent commission on all gross sales of candy, gum, and nuts sold by Canteen Service through vending machines at all locations within Lucas, Fulton, and Wood Counties, Ohio, where Gladco "now or hereafter operate[s] cafeterias, lunch counters or other food dispensing facilities." Pursuant to that provision and prior to 1958, Canteen Service paid a 12 percent location commission to Gladco on sales made by Canteen Service through vending machines located at the facilities of Libbey-Owens-Ford Glass Company (hereinafter LOF Glass). The 1946 agreement further provided that Canteen Service would assume Gladco's obligation to pay to the owners of the locations where Gladco vending machines were operated, but where no counter food was sold, an 8 percent commission on the gross sales of candy, gum, and nuts sold through vending machines. It was provided, however, that Canteen Service would not be required to pay Gladco any commission on sales made through vending machines at such locations.[5]

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[5] While Southeastern never entered into any written agreement respecting payment of location commissions to Gladco, it followed the same pattern of paying such commissions on vending business generated by Gladco's in-plant feeding business as did Canteen Service.

Prior to 1958, Canteen Service had paid location commissions to Virgil on the LOF Glass business. In 1958, LOF Glass negotiated for location commissions to be paid directly to it by Canteen Service. Subsequently, Canteen Service, as the result of a waiver by Virgil and the Gladieux interests, neither paid nor accrued any further location commissions to Virgil or Gladco on the LOF Glass business until October 1, 1960, when such payments were again required pursuant to the sale-leaseback agreement between Canteen Service and Gladco, dated January 1, 1961.

Beginning in 1953, Canteen Service paid location commissions to Toledo Scale. Although Canteen Service did not pay Virgil or Gladco additional location commissions, as a result of negotiations between Virgil and Toledo Scale in 1955 or 1956, Toledo Scale thereafter remitted to Gladco approximately 85 percent of the commissions received by Toledo Scale from Canteen Service. Canteen Service, however, never paid or accrued location commissions directly to Gladco for vending machine sales at Toledo Scale until October 1, 1960, pursuant to the sale-leaseback agreement between Canteen Service and Gladco, dated January 31, 1961.

The transfer of Gladco's vending operations to Canteen Service, pursuant to the agreement of May 10, 1946, appealed strongly to Virgil for financial reasons since, pursuant to Automatic's franchise arrangement under which Canteen Service was then operating, Canteen Service could lease its vending equipment from Automatic whereas up to that time Gladco was compelled to purchase such equipment thereby limiting its financial resources for expansion. The agreement also appealed to Gladco inasmuch as it provided an option pursuant to which Gladco could purchase up to 75 percent of the stock in

Canteen Service on or before October 31, 1946. In the event such option was exercised and in the further event Handwork or Gladco later wished to sell their respective stockholdings, they were required to offer them to each other under a reciprocal right of first refusal. Gladco later exercised its right of purchase, and as a result of Canteen Service's subsequent redemption of Handwork's 25 percent stock interest in Canteen Service, Gladco became the sole owner of Canteen Service.

After May 10, 1946, as vending machines were adapted to handle food products other than candy, gum, and nuts, such as milk, coffee, and ice cream, Virgil and Gladco exacted varying rates of location commissions from Canteen Service depending upon the relative profit margins of the foods being vended as well as the amount of location commissions Gladco was required to pay to its industrial clients. Thus in time there arose an inconsistent pattern of location commissions payable to Gladco by Canteen Service.

On or about December 4, 1953, Gladco began operating a restaurant and cafeteria at the plant and facilities of Toledo Scale Co. of Toledo, Ohio (hereinafter Toledo Scale), and continued such operations throughout Canteen Service's taxable year in question. Also, about December 4, 1953, Canteen Service was permitted to install canteens at nine different plant locations of Toledo Scale.

For a period occurring between 1953 and 1960, Gladco waived the location commissions payable to it by Canteen Service on the Toledo Scale business and did not again require commission payments to be made to it on that business until the sale-leaseback agreement entered into between it and Canteen Service on January 31, 1961, which agreement increased such commission payments retroactively to October 1, 1960.

Gladco, during the years in question, operated various food systems, such as in-plant employees feeding concerns, cafeterias, snack bars, and dining rooms. During those years and until February 2, 1961, of the outstanding capital stock of Gladco, consisting of 500 no par common shares, 499 shares were owned by Virgil and the remaining share by his wife.

On June 30, 1960, Virgil and his wife owned the entire outstanding capital stock of 15 corporations engaged in the merchandising and vending of food, beverages, cigarettes, and gum. Included among those 15 corporations were Canteen Service, Southeastern, and Gladco.

Immediately prior to June 30, 1960, ABC Vending Corporation (whose name has since been changed to ABC Consolidated Corporation and hereinafter will be referred to as ABC) was primarily engaged in the food and beverage merchandising and vending business with book net worth in excess of $16 million and with annual sales from its vending business exceeding $60 million. At that time, ABC was a publicly owned corporation with stock listed on the New York Stock Exchange. In January of 1961, it had 8,522 shareholders who owned 1,228,328 shares of common stock. Additionally, it held 48,960 shares of treasury stock. Prior to February 2, 1961, neither Virgil nor his wife owned any capital stock of ABC.

On June 30, 1960, ABC and Virgil entered into an agreement whereby Virgil agreed, among other things, to transfer to ABC all of the outstanding capital stock of the 15 corporations owned by him and his wife, in exchange for 80,000 shares of the capital common stock of ABC. The agreement provided that Virgil was to be retained by ABC in a "major managerial capacity" at an annual salary of

$62,500 for 5 years, after which his salary would be increased to $67,500. The agreement further provided that ABC would deliver to Virgil a stock option certificate giving him the right to acquire 5,000 shares of ABC common stock at a price equal to 85 percent of the market value of the stock on the New York Stock Exchange on the date of settlement of the foregoing agreement.

Automatic, relying on the provisions of the franchise agreement which it had entered into with Canteen Service on July 1, 1947, refused to consent to Virgil's attempted transfer to ABC of the outstanding capital stock of Canteen Service and Southeastern.[6] Pursuant to a section of that agreement which defined the procedure for handling a dispute as to petitioners' right to transfer, Automatic's refusal to consent to the sale and transfer was submitted to arbitration. On December 27, 1960, the arbitration tribunal decided that the withholding of such consent by Automatic was not unreasonable, arbitrary, or capricious.

Subsequent to the arbitration decision, Virgil and ABC executed a "Supplemental Agreement" on January 26, 1961, amending their agreement of June 30, 1960, by eliminating from the 1960 agreement the requirement that Virgil transfer the outstanding stock of Canteen Service and Southeastern to ABC. The amendatory agreement also reduced the number of ABC shares to be delivered to Virgil from 80,000 to 68,500.

Also, on January 26, 1961, Virgil, ABC, Canteen Service, Southeastern, and Gladco executed an agreement which provided that since Virgil was no longer able to transfer petitioners' stock to ABC, Gladco and petitioners

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[6] The franchise agreement provided that petitioner could not, without the consent of Automatic, sell, assign, or transfer any interest in the agreement. It further provided that Automatic would not "unreasonably, arbitrarily or capriciously" withhold its consent to such a sale, assignment, or transfer.

would enter into an agreement which would provide, among other things, that: (1) petitioners would sell and transfer to Gladco their designated tangible physical assets in the following amounts: $184,659.85 as to Canteen Service and $5,109.43 as to Southeastern;[7] (2) Gladco would lease back to petitioners all such assets for a term of 20 years from October 1, 1960, with the further agreement that during that term Gladco would provide and lease to petitioners "all additional equipment necessary for the operation of the vending machine business" conducted by petitioners;[8] (3) petitioners would pay to Gladco for such leased assets a "rental" equal to 10 percent of the gross sales from the vending machine business "on and after October 1, 1960, and until the end of the term of the said lease and any extended term thereof";[9] (4) such "rentals" were not to be such in amount as would create a deficit in net income of either petitioner, net income being computed—

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[7] The amount Gladco agreed to pay petitioners for their tangible physical assets constituted their net book value, after accrued depreciation as shown on petitioners' books as of October 1, 1960. Included in such assets transferred were 299 vending machines owned by Canteen Service and 4 vending machines owned by Southeastern. Journal entries reflecting the sale were posted on the books of Gladco and each petitioner on February 18, 1961.

[8] For the period October 1, 1960, through December 27, 1964, Gladco purchased "additional equipment" for lease to petitioners in the following amounts: As to Canteen Service, $595,591.12, and as to Southeastern, $12,097.91. For the period October 1, 1960, through December 1962, "additional equipment" in the amount of $66,537.18 was purchased for Canteen Service.

[9] For the period October 1, 1960, through October 3, 1964, petitioners made "rental" payments to Gladco in the following amounts: Canteen Service, $432,835.18 and Southeastern, $62,487.98. For the period October 1, 1960, through September 1962, Canteen Service made "rental" payments to Gladco totaling $208,176.58.

> before Federal income taxes and before any salaries or expenses paid to or attributable to Virgil A. Gladieux or any member of his family, * * *

(5) any income, loss, or expense of petitioners "derived from or attributable to marketable securities or any other investment not germane to the operation of the vending machine business" was to be excluded from the determination of such net income; (6) petitioners were to pay increased fixed location commissions to Gladco as of October 1, 1960, with respect to all sales at all vending locations derived through Virgil, Gladco, or any affiliated corporations; and (7) Gladco could, at its option, extend the lease provisions for four consecutive periods of 20 years each. An agreement, dated January 31, 1961, containing the foregoing provisions, was executed by Gladco with each petitioner.[10] On February 2, 1961, pursuant to the terms of the "Supplemental Agreement" between Virgil and ABC, ABC delivered 68,500 shares of its capital common stock to Virgil and his wife in the respective amounts of 54,200 and 14,300 shares. On that same day, Virgil and his wife transferred to ABC the outstanding shares of stock in 13 corporations wholly owned by them, constituting all of the corporations referred to in the agreement dated June 30, 1960, with the exception of Canteen Service and Southeastern.

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[10] During the negotiations between ABC and Virgil in the latter part of 1960 and early part of 1961, which culminated in the January 1961 agreements, Virgil was of the view that the representatives of ABC contemplated that the sale-leaseback arrangements provided for in those agreements would take most of petitioners' profits. As anticipated, the leaseback arrangements absorbed all of the profits, with the exception of dividends from petitioners' ABC stock, of Canteen Service for its 1961 through 1963 fiscal years, and Southeastern for its 1961 through 1964 fiscal years.

The $184,659.85 received by Canteen Service under the January 31, 1961, agreement, together with an additional $201,827.30 of its other funds, was used by Canteen Service to purchase shares of ABC stock in the spring of 1961. Similarly, the $5,109.43 received by Southeastern under the January 31, 1961, agreement, together with an additional $52,863.64 of its other funds, was used by Southeastern to purchase ABC stock in the spring of 1961.[11] The total investment by petitioners of $444,460.22 in the spring of 1961, was used to purchase 11,500 shares of ABC stock.

During the negotiations between ABC and Virgil which were carried on both before and after the arbitration decision, Canteen Service was the owner of an 8½-acre parcel of vacant land, purchased by it in 1959, and located in Toledo, Ohio. Efforts were then being made by Canteen Service to sell the property and on April 27, 1961, the property was sold for $75,000 resulting in a net gain to Canteen Service, after expenses of sale, of $33,238.50. This property was not included in the assets of Canteen Service sold to Gladco under the agreement dated January 31, 1961, and Gladco at no time held title to this property.

For the fiscal year ended September 30, 1961, Canteen Service paid or accrued on its books as a liability in favor of Gladco, as purported rentals under the January 31, 1961, agreement, the sum of $121,172.15, including an amount of $28,897.95 with respect to the 8½-acre parcel

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[11] Although the January 31, 1961, agreement between Gladco and each petitioner provided that Gladco would deliver to each petitioner its promissory note in the amount of the respective purchase price, the journal entries on the books of Canteen Service and Southeastern, recording the sale of assets to Gladco, recited that Gladco "gave a note to ABC Vending Corporation for * * * [stated dollar amount] and we received check from ABC Vending Corporation."

sold by Canteen Service on April 27, 1961.[12] Canteen Service subsequently deducted the purported rentals from its gross income for its fiscal year 1961. During the calendar years 1960 and 1961, Gladco included as rental income, in its taxable income, the amount of $121,172.15 so paid to it or accrued as a liability in its favor by Canteen Service. Respondent allowed Canteen Service a rental deduction in the amount of $53,592.79 for the fiscal year ended September 30, 1961. The amount so allowed constituted the total depreciation, on a straight line method with various lives, charged off and deducted as an expense by Canteen Service for the fiscal year ended October 1, 1960, on the buildings, improvements, trucks, machinery, equipment, furniture, fixtures, and vending machines transferred by Canteen Service to Gladco pursuant to the agreement of January 31, 1961, thus disallowing as a deduction from the taxable income of Canteen Service $67,579.36 of such rentals so paid or accrued.

During the fiscal year ended September 30, 1961, Southeastern paid or accrued on its books as a liability in favor of Gladco, as purported rentals under the January 31, 1961, agreement, the sum of $12,211.30. Southeastern subsequently deducted the purported rentals from its gross income for its fiscal year 1961. During the calendar years 1960 and 1961, Gladco included as rental income in its taxable income the amount of such rentals so paid to it or accrued as a liability in its favor by Southeastern during the fiscal year ended September 30, 1961. Respondent allowed Southeastern a rental deduction in the amount of $1,906.59, for the fiscal year ended September 30, 1961.

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[12] During the negotiations between Virgil and representatives of ABC leading to the agreements of January 1961, it was agreed that the profit from the sale of this land would be included in the operating income of Canteen Service for the purpose of computing "rentals" under the contemplated contracts.

The amount so allowed constituted the total depreciation, on a straight line method with various lives, charged off and deducted as an expense by Southeastern for the fiscal year ended October 1, 1960, on the trucks, furniture, fixtures, and vending machines assigned by Southeastern to Gladco pursuant to the agreement of January 31, 1961, thus disallowing as a deduction from the taxable income of Southeastern $10,304.71 of such rentals so paid or accrued.

For the accounting periods ended October 29, 1960, November 26, 1960, December 24, 1960, January 22, 1961, and February 20, 1961, location commissions payable by Canteen Service to Gladco under their agreement of January 31, 1961, were retroactively increased and accrued, from and after October 1, 1960, by journal entries made to the books of Canteen Service on March 18, 1961. On April 15, 1961, Canteen Service paid these accruals to Gladco. The foregoing location commissions, as well as the location commissions paid or accrued for the accounting periods of Canteen Service commencing February 21, 1961, and ended September 30, 1961, together with the portions thereof which were allowed and disallowed by the Commissioner were as follows:[13]

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[13] In addition to locations commissions paid or accrued to Gladco by Canteen Service for its fiscal year 1961, Canteen Service also paid such commissions directly to LOF Glass in the amount of $8,656.76 and to Toledo Scale in the amount of $3,744.94.

Location Commissions Paid or Accrued by Canteen Service to Gladco

Origin of commissions	Accounting Periods Ended October 29, 1960 November 26, 1960 December 24, 1960		Ended January 22, 1961 February 20, 1961		February 21, 1961 to September 30, 1961		Total Fiscal year ended September 30, 1961	
	Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed
LOF Glass		$18,962.79		$10,107.40		$31,038.92		$60,109.11
Toledo Scale		2,280.44		1,451.31		5,588.30		9,320.05
All other business	$13,541.09[1]	3,043.45[2]	$7,799.03[1]	1,615.65[2]	$39,492.30[3]		$60,832.42	4,659.10
Total	13,541.09	24,286.68	7,799.03	13,174.36	39,492.30	36,627.22	60,832.42	74,088.26

[1] The location commissions allowed on "All other business" were determined under rates in effect prior to the January 31, 1961, agreement between Canteen Service and Gladco. The Commissioner further allowed as a deduction the amount of $28,547.88, which constituted all location commissions paid or accrued by Canteen Service during the fiscal year ended September 30,1961, with respect to all those locations which were not subject to the provisions of the agreement of January 31, 1961.

[2] The location commissions disallowed on "All other business" were the excess of the commissions, as computed under the rates set forth in Schedule II of the January 31, 1961, agreement between Canteen Service and Gladco, over the rates in effect prior to the agreement of January 31, 1961.

[3] These location commissions were determined under the increased rate structure established in Schedule II of the January 31, 1961, agreement between Canteen Service and Gladco.

Location commissions in the amount of $74,088.26 which were paid or accrued by Canteen Service for the fiscal year ended September 30, 1961, and which were disallowed by respondent as a deduction from the gross income of Canteen Service for Federal income tax purposes for said fiscal year, were included in the taxable income of the following corporations in the amounts and for the taxable years as follows:

Included by Gladco in its 1960 Federal income tax return	$24,286.68
Included by Gladco in its 1961 Federal income tax return	44,213.28
Included by Buddies of Lucas County, Inc. (one of the Gladco companies acquired by ABC) in its 1961 Federal income tax return	5,588.30
Total	74,088.26

For the accounting periods ended October 29, 1960, November 26, 1960, December 24, 1960, January 22, 1961, and February 20, 1961, location commissions payable by Southeastern to Gladco under their agreement of January 31, 1961, were retroactively increased and accrued, from and after October 1, 1960, by journal entries made to the books of Southeastern on March 18, 1961. The foregoing location commissions, as well as the location commissions paid or accrued for the accounting periods of Southeastern commencing February 21, 1961, and ended September 30, 1961, together with the portions thereof which were allowed and disallowed by the Commissioner, are as follows:

Location commissions in the amount of $1,593.84 which were paid or accrued by Southeastern for the fiscal year ended September 30, 1961, and which were disallowed by respondent as a deduction from the gross income of Southeastern for Federal income tax purposes for

Location Commissions Paid or Accrued by Southeastern to Gladco

Accounting Periods						Total	
Ended		Ended					
October 29, 1960 November 26, 1960 December 24, 1960		January 22, 1961 February 20, 1961		February 21, 1961 to September 30, 1961		Fiscal year ended September 30, 1961	
Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed	Allowed	Disallowed
$1,138.63[1]	$995.63[2]	$825.89[1]	$598.21[2]	$5,616.21[3]	—	$7,580.73	$1,593.84

[1] The location commissions allowed were determined under rates in effect prior to the January 31, 1961, agreement between Southeastern and Gladco. The Commissioner further allowed as a deduction the amount of $2,046.81, which constituted all location commissions paid or accrued by Southeastern during the fiscal year ended September 30, 1961, with respect to all those locations which were not subject to the provisions of the agreement of January 31, 1961.

[2] The location commissions disallowed were the excess of the commissions, as computed under the rates set forth in Schedule II of the January 31, 1961, agreement between Southeastern and Gladco, over the rates in effect prior to the agreement of January 31, 1961.

[3] These location commissions were determined under the increased rate structure established by Schedule II of the January 31, 1961, agreement between Southeastern and Gladco.

said fiscal year, were included in the taxable income of Gladco in its Federal income tax returns as follows:

For the year 1960	$995.63
For the year 1961	598.21
Total	1,593.84

OPINION.

Issue 1. Purported Rental Payments.

For the fiscal year ended September 30, 1961, Canteen Service and Southeastern claimed as a deduction for purported rental payments, the respective amounts of $121,172.15 and $12,211.30, constituting the amounts they paid Gladco under certain sale-leaseback agreements dated January 31, 1961. Respondent has determined that the amounts so claimed are excessive to the extent that they exceed $53,592.79 as to Canteen Service and $1,906.59 as to Southeastern. Petitioners' principal contention appears to be that since the contracts imposing the questioned rentals were the result of arm's length negotiation between unrelated parties having adverse interests, the claimed rental deductions are not subject to attack by respondent as being unreasonable. Thus, it is argued that under the relevant statutory provision, section 162(a)(3) of the 1954 Code,[14] if the purported rentals were required to be paid pursuant to an arm's length agreement, the

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[14] Sec. 162. Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

reasonableness of the rentals so paid cannot be judicially assailed. In considering a similar contention in *Roland P. Place,* 17 T. C. 199, 203 (1951), affd. 199 F.2d 373 (C.A. 6, 1952), certiorari denied 334 U.S. 927 (1953), this Court stated:

> The basic question is not whether these sums claimed as a rental deduction were reasonable in amount but rather whether they were in fact rent instead of something else paid under the guise of rent. The inquiry is whether the petitioner was in fact and at law "required" to pay these sums as rent. * * * When there is a close relationship between lessor and lessee and in addition there is no arm's length dealing between them, an inquiry into what constitutes reasonable rental is necessary to determine whether the sum paid is in excess of what the lessee would have been required to pay had he dealt at arm's length with a stranger. * * * [15]

Even though petitioners' contention might be correct if the purported rentals at issue were in fact arrived at as the result of arm's length negotiation between adverse parties, it is incumbent upon this Court to determine, in the first instance, whether such is in fact the case. In an attempt to support their position, that the sale-leaseback agreements were arrived at by arm's length negotiation between adverse parties, petitioners contend that those agreements arose out of negotiations between representatives of ABC, who, on the one hand, were representing Gladco, and Virgil, who, on the other hand, was representing petitioners. According to this theory, since ABC was to acquire Gladco from Virgil, ABC was interested in securing the best possible rental agreement for Gladco, whereas

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[15] To the same effect, see *J. J. Kirk, Inc.,* 34 T. C. 130 (1960), affd. per curiam 289 F. 2d 935 (C. A. 6, 1961); *Southern Ford Tractor Corporation,* 29 T. C. 833 (1958); and *E-Z Sew Enterprises, Inc. v. United States,* 260 F. Supp 100 (E. D. Mich. 1966).

Virgil, being the owner of Canteen Service and Southeastern, was striving to—

1. maintain the close relationship which had theretofore existed between Gladieux Corporation and Petitioners, since Gladieux Corporation had generated more than seventy-five per cent (75%) of the vending business enjoyed by Petitioners,

2. assure the Petitioners against any operating loss as the result of the rental arrangement, and

3. assure the Petitioners of the availability of funds for expansion, for acquisitions of other vending companies which he then had in mind and for the eventual purchase by Gladieux Corporation of the vending machines then being rented by the Petitioners from Automatic at no additional cost to Petitioners.

While the foregoing objectives may have existed in Virgil's mind prior to the execution of the sale-leaseback agreements, we are convinced, from a thorough consideration of the entire record, that such objectives were subservient to Virgil's principal objective of consummating a business deal with ABC along the lines established by their agreement of June 30, 1960.

Thus, the true motivating force for the sale-leaseback agreements was a desire on the part of Virgil to transfer his interest in his food service companies in exchange for an executive position with ABC at a starting salary of $62,500, acquisition of 80,000 shares of ABC stock, and a stock option for an additional 5,000 shares of ABC stock at 85 percent of market value. However, when Automatic, who was petitioners' franchisor as well as a competitor of ABC, objected to the transfer of petitioners' stock to ABC, and that objection was upheld by an arbitration award, it became necessary for Virgil to devise an alternative plan for accomplishing the same results without transferring

petitioners' stock to ABC. As shown by the record, Virgil and ABC agreed to a plan whereby Virgil would transfer ownership in 13 of his 15 companies to ABC, and funnel the profits of the remaining 2 companies, Canteen Service and Southeastern, into Gladco by way of the sale-leaseback agreements. While that plan did not secure to ABC the ownership of all 15 of Virgil's food service companies as ABC originally desired, the effect of the several agreements between the parties accomplished much the same thing inasmuch as ABC acquired stock ownership in 13 of the 15 companies and received, under the provisions of the sale-leaseback agreements, virtually all the profits of Canteen Service and Southeastern. Virgil, on the other hand, obtained his executive position with ABC, received 68,500 shares of ABC stock, and acquired the option to purchase 5,000 additional shares of ABC stock at 85 percent of market value. Shortly after the foregoing results were accomplished, Virgil caused petitioners to collectively purchase 11,500 shares of ABC stock, thereby securing to himself, directly and through his ownership of petitioners, the 80,000 shares of ABC stock originally contemplated by the June 30, 1960, agreement between himself and ABC.

The dominant motives of both Virgil and ABC throughout the negotiations which culminated in the sale-leaseback agreements are crystal clear. Virgil sought to obtain ABC stock and an executive position with the company and ABC sought to acquire Virgil's 15 food service companies. In light of these facts, we think it abundantly clear that the sale-leaseback agreements were designed solely to fulfill the personal objectives of Virgil. There was no legitimate business purpose for petitioners to undertake the sale and subsequent leaseback of their tangible assets other than to satisfy Virgil's purpose of shifting income from petitioners to Gladco in order to induce ABC

to go through with the deal. Thus, this is not a case where a corporation entered a sale-leaseback arrangement in order to generate needed cash for business expansion. To the contrary, all the money received by petitioners upon the sale of their tangible assets, together with substantial additional amounts, was used to purchase ABC stock, thus serving no meaningful business purpose to petitioners.

Petitioners' position is further weakened by the fact that during the entire negotiations leading up to the execution of the sale-leaseback agreements, the owner of both the lessor (Gladco) and the lessees (petitioners) was the same person, Virgil Gladieux. Petitioners' attempt to transform such an identity of interest into a relationship which petitioners characterize as adverse, transgresses reasonable imagination. All the more so since the facts show that the sale-leaseback agreements were not intended to be ends in themselves but merely steps in an integrated plan to secure to Virgil and ABC advantages which could not benefit petitioners in any meaningful way. From a review of all the facts bearing on this issue, which have been set out at length in our findings, we are convinced that the sale-leaseback agreements in question were not the result of arm's length negotiation between adverse parties and, therefore, we must determine whether the purported rentals were "in excess of what the lessee [s] would have been required to pay had * * * [they] dealt at arm's length with a stranger." *Roland P. Place, supra.*

The terms of the sale-leaseback agreements provided that petitioners were to make purported rental payments to Gladco equal to 10 percent of petitioners' gross sales on and after October 1, 1960, derived from their vending machine business. The agreements provided, however, that if for any annual fiscal period any rent payable to

Gladco would result in a deficit to petitioners' net income, then such rental would be "abated or refunded in such amount as to eliminate such deficit." The contract provided that net income, as used to calculate the existence of a deficit, was to be determined—

> before Federal income taxes and before any salaries or expenses paid to or attributable to Virgil A. Gladieux or any member of his family, and excluding from the determination of such net income any income, loss or expense of * * * [petitioner] from or attributable to marketable securities or any other investment not germane to the operation of the vending machine business of * * * [petitioner].

For the fiscal year ended September 30, 1961, 10 percent of Canteen Service's sales amounted to $165,149.03 and 10 percent of Southeastern's sales amounted to $17,006.69. Inasmuch as the payment of such "rental" would have resulted in a deficit to petitioners' net operating income for that year, the rentals payable to Gladco under the provisions of the January 31, 1961, contract were reduced as to Canteen Service and Southeastern, to $121,172.15 and $12,211.30, respectively. The foregoing amounts were subsequently claimed by petitioners as rental deductions in their tax returns for their fiscal year 1961.

As to the claimed deductions for the period commencing October 1, 1960, and ended January 31, 1961, we failed to perceive how the amounts paid during that period could satisfy the statutory requirements of section 162(a)(3). That provision specifically provides that to constitute a deductible expense, the payment must be—

> required * * * as a condition to the continued use or possession * * * *of property to which the taxpayer has not taken or is not taking title or in which he has no equity.* [Emphasis supplied.]

The sale-leaseback agreements were not executed before January 31, 1961. The language employed in those agreements in no way suggests that petitioners were attempting to sell their tangible assets to Gladco as of October 1, 1960. To the contrary, the opening paragraph of the respective agreements states that petitioner "hereby sells, transfers and assigns to Gladieux Corporation," thereby evidencing an intent on petitioners' part to make a present sale of their assets on January 31, 1961. While it is true that the agreements subsequently recite that Gladco "hereby leases" to petitioners the aforementioned tangible assets "for a term of twenty years from October 1, 1960," the retroactive aspect of this lease provision can in no way convert ownership of petitioners' assets to Gladco. It follows, that petitioners had not parted with title to their tangible assets, at least until the execution of the sale-leaseback agreements on or after January 31, 1961. That being the case, the retroactive payments made by petitioners to Gladco for the 4-month period from October 1, 1960, to January 31, 1961, was for property which petitioners owned. Such payments are therefore not deductible as rentals under the explicit language of section 162(a)(3) of the Code. The fact that payments were designated as "rentals" and Gladco may have had an enforceable contract right against petitioners for the amounts so designated, in no way alters this result. As we stated in *Catherine G. Armston*, 12 T.C. 539, 548 (1949), affd. 188 F.2d 531 (C.A. 5, 1951):

> the mere designation of * * * amounts as rental does not legally characterize them as such. Nor does the fact that as between the * * * [lessor and lessees], the parties to the agreement, the obligation to pay may have been enforceable, render the payment deductible as rent or otherwise * * *

Equally objectionable is Canteen Service's inclusion in its claimed rental deduction of the amount of $28,897.95 which constitutes part of the profits realized by Canteen Service upon the sale of an 8½-acre vacant lot on April 27, 1961. Although Canteen Service paid or accrued this amount on its books as a liability in favor of Gladco, as purported rental under the sale-leaseback agreement, the facts as well as the applicable Code provision fail to support petitioners' treatment of this item as a "rental" deduction. The sale-leaseback agreement provided that the "rental" payment would be equal to 10 percent of Canteen Service's gross sales from its vending machine business, with the further provision that the annual "rental" would not be permitted to cause a deficit in Canteen Service's "net income." The agreement further provided that "net income," as used in the rental formula, would exclude income "derived from or attributable to marketable securities or any other investment not germane to the operation of the vending machine business of Canteen [Service]." Since the foregoing contract provisions were in effect at the time the land in question was sold, the profits derived from its sale could not have been included in Canteen Service's net income for purposes of calculating its "rental" liability to Gladco without violating the express provisions of the sale-leaseback agreement. The fact that the profits so derived were included in Canteen Service's net operating income for purposes of calculating the "rental" payment, lends additional support to the fact that the series of transactions entered into among petitioners, Gladco, ABC, and Virgil in January 1961 were intended to shift virtually all of petitioners' income to Gladco rather than to serve any legitimate business purpose of petitioners. However, an additional and more serious objection arises with regard to petitioners'

treatment of the real estate profits as "rental." Section 162(a)(3) of the Code specifically excludes as rental deductions, amounts paid for the use of property where title remains in the taxpayer-lessee. Since we have previously found that the land in question was never sold to Gladco by Canteen Service, and that Gladco at no time held title to such property, any "rental" payments made to Gladco by Canteen Service with respect to profits derived from the sale of that land could not satisfy the relevant statutory provision. Thus, as to the purported rentals paid on the profits derived from the sale of Canteen Service's vacant land, we hold that respondent's disallowance was proper.

In determining the reasonableness of the remaining amounts claimed by petitioners as rental deductions for the fiscal year 1961, one factor which we deem significant is the gross disparity between the price Gladco paid petitioners for their tangible assets and the purported rentals petitioners were required to pay Gladco in fiscal 1961 in order to lease back those same assets. In 1961 Canteen Service transferred its office, warehouse, trucks, cars, furniture, fixtures, vending machines, and related hardware to Gladco for $184,659.85, and yet was required to pay a purported rental of $121,172.15 in order to lease back those same assets for 8 months. For the same year, Southeastern similarly transferred its car, trucks, furniture, fixtures, vending machines, and related hardware to Gladco for $5,109.43, and was required to pay a purported rental of $12,211.30 in order to lease back those same assets for 8 months. It is evident that the payments made by petitioners in 1961 as "rentals" were patently excessive and bore no reasonable relationship to an amount which would be required to be paid as rentals for such assets if the petitioners had dealt with a lessor at arm's

length. *Limericks, Inc.*, 7 T.C. 1129 (1946), affd. 165 F.2d 483 (C. A. 5, 1948). Petitioners contended, however, that since the sale-leaseback agreements further required Gladco to "provide and lease to * * * [petitioners] all additional equipment reasonably necessary," the purported rentals were not unreasonable. Under the contract provision relied upon, the determination of how much, if any, additional equipment "was reasonably necessary" was apparently a judgment which Gladco alone would make. The record discloses that for the period October 1, 1960, through October 3, 1964, Southeastern paid Gladco total "rentals" of $62,487.98, receiving in return, for the period October 1, 1960, through December 27, 1964, "additional equipment" costing Gladco $12,097.91. For the same periods, Canteen Service paid Gladco total "rentals" of $432,835.18, receiving in return "additional equipment" costing Gladco $595,591.12. Thus, Southeastern paid Gladco $62,487.98 to "lease" equipment valued by the parties at $5,109.43 and $12,097.91, for a total amount of $17,207.34. Similarly Canteen Service paid Gladco $432,835.18 to "lease" equipment valued by the parties at $184,659.85 and $595,591.12, or a total of $780,250.97. With regard to Canteen Service, an even greater disparity occurred for the period October 1, 1960, through approximately December 1962. During that period Gladco leased to Canteen Service former assets valued at $184,659.85 plus additional assets costing Gladco $66,537.18, or total assets of $251,197.03. As of September 29, 1962, Canteen Service had paid Gladco $208,176.58 in rentals. The unreasonableness of such rentals is striking. The amounts paid by petitioners were almost sufficient to purchase outright the assets "leased." Considering the gross disparity existing between the value of the properties rented to petitioners and "rentals" obtained by

Gladco under the sale-leaseback agreements, we must reject petitioners' contention that Gladco's obligation to provide "all additional equipment reasonably necessary" for petitioners' vending machine operations justified their otherwise excessive "rentals." We have carefully considered the many alternative contentions presented by the parties respecting the rental issue and are satisfied that they do not alter our conclusion that the purported rentals paid by petitioners to Gladco for their fiscal year ended September 30, 1961, were grossly excessive, did not represent the fair rental value of the assets leased, and would not have been "required" to be paid by petitioners had they negotiated at arm's length with an adverse party. Having so concluded, we must hold that the amount respondent determined to be the maximum petitioners would have been required to pay must stand, since it has not been shown to be patently inadequate. *Roland P. Place, supra.*

ISSUE 2. LOCATION COMMISSIONS.

During their fiscal year 1961, Canteen Service and Southeastern paid or accrued total location commissions of $163,468.56 and $11,221.38, respectively. Of those amounts Canteen Service paid or accrued to Gladco $134,920.68 and Southeastern paid or accrued to Gladco $9,174.57. Of the amounts paid or accrued to Gladco by petitioners, respondent disallowed $74,088.26 as to Canteen Service and $1,593.84 as to Southeastern.

The $74,088.26 disallowed Canteen Service consists of two components, location commissions paid or accrued to Gladco for sales at LOF Glass and Toledo Scale, and location commissions paid or accrued to Gladco for "all other business." The amount of the disallowances attributable to the LOF Glass and Toledo Scale business was

$69,429.16, which constituted the entire location commissions claimed by Canteen Service as to those customers. The remaining amount disallowed, $4,659.10, constituted the excess in location commissions for Canteen Service's accounting periods beginning October 1, 1960, and ending February 20, 1961, on all Canteen Service's other business as computed under the rates set forth in the January 31, 1961, agreement between Canteen Service and Gladco, over the rates in effect under the May 10, 1946, agreement.[16] The $1,593.84 disallowed Southeastern constituted the excess in location commissions, for its entire 1961 fiscal year, as computed under the rates set forth in the January 31, 1961, agreement between Southeastern and Gladco, over the rates in effect prior to that agreement.

Respondent has thus disallowed location commissions which fall into two categories. The first category is composed of the disallowance of all location commissions paid or accrued to Gladco by Canteen Service for sales at Toledo Scale and LOF Glass, for Canteen Service's 1961 fiscal year. The second category covers a partial disallowance of location commissions paid or accrued on Canteen Service's business, other than LOF Glass and Toledo Scale, and all of Southeastern's business, for the period October 1, 1960, through February 20, 1961.

The basic issue is whether that portion of the location commissions paid or accrued by petitioners in their fiscal year 1961, and which has been disallowed by respondent, constituted "ordinary and necessary expenses" to petitioners under section 162(a) of the Code. Petitioners contend, and respondent appears to concede, that the statu-

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[16] Respondent allowed all location commissions claimed on this latter component, "all other business," for the remainder of Canteen Service's fiscal year, February 21, 1961, through September 30, 1961.

tory requirement of "ordinary and necessary" is satisfied provided the claimed deduction is for an expense which is merely "appropriate and helpful" to the development of the taxpayer's business, citing the case of *Commissioner v. Tellier*, 383 U. S. 687 (1966). In applying such a standard to the instant case, it has been necessary to consider a multitude of facts, many of which have been contested by the parties, in an attempt to reconstruct a meaningful fact pattern. After careful consideration of all the relevant facts bearing on this issue, as well as the numerous arguments presented by both parties, we are of the view that respondent's disallowance of petitioners' location commissions must be sustained.

With respect to the disallowance of Canteen Service's commission payments to Gladco for sales at LOF Glass and Toledo Scale, we are convinced that such payments satisfied no meaningful business purpose of Canteen Service, but rather, constituted only a further effort on the part of Virgil Gladieux to transfer virtually all petitioners' income to Gladco and thereby secure to himself an executive position with ABC at a starting salary of $62,500, as well as to acquire 80,000 shares of ABC stock.

Petitioners contend that the location commissions paid to Gladco by Canteen Service for the year in question arose out of a contractual obligation between Canteen Service and Gladco which was negotiated at arm's length in 1946, and was rewritten in 1961 in order to standardize the rate structure on Canteen Service's business, a change allegedly made necessary by the increased number of foods used in Canteen Service's vending machines as well as the different location commission rates prevailing in different geographical areas for the same foods.

We do not question that the 1946 agreement between Canteen Service and Gladco was negotiated at arm's length

between adverse parties. At that time Gladco was owned equally by Virgil and his brother Nelson, and Canteen Service was owned by an unrelated party, Ben Handwork. The weakness in petitioners' contention, however, is that all location commissions in question arose out of the 1961 agreement, not the agreement of 1946, and as we have already determined under issue 1, *supra,* the 1961 agreement was entered into between corporations wholly owned by Virgil and his wife, for the principal purpose of shifting income from petitioners to Gladco and not for any meaningful business purpose as far as petitioners were concerned. This conclusion is further supported by the fact that prior to the 1961 agreement, imposing increased location commissions on petitioners retroactively to October 1, 1960, Gladco had waived all commission payments due from Canteen Service on the LOF Glass and Toledo Scale business. The waivers as to those commission payments occurred at the time Canteen Service began making location commission payments directly to the industrial clients, LOF Glass and Toledo Scale. Thus, for several years prior to the 1961 agreement, Canteen Service was not required to make any location commission payments to Gladco on its LOF Glass and Toledo Scale business. However, in order for Virgil's deal with ABC to be consummated, it became necessary to shift all income of petitioners to Gladco. To accomplish this objective Canteen Service was required to reinstitute location commission payments to Gladco on its LOF Glass and Toledo Scale business, which was, of course, in addition to the amounts Canteen Service was required to pay Gladco as purported rental payments. We can find no reasonable explanation for reinstituting such location commissions except as a further device to accomplish the shifting of all petitioners' income to Gladco. The record specifically shows that at the time Virgil was

negotiating with representatives of ABC, he felt ABC was intending to acquire, by the various agreements, all the operating income of petitioners.

Even more objectionable to allowing Canteen Service's location commissions in question is the fact that not only prior to, but for the year in question, Canteen Service paid location commissions directly to LOF Glass and Toledo Scale for the right to operate vending machines on the premises of those industrial customers. In 1961, Canteen Service paid to those customers the combined amount of $12,401.70 in location commissions. In spite of this, petitioners contend that they are entitled to deduct the further amount of $69,429.16 paid to Gladco as location commissions for vending machine sales on the premises of the same two customers. The record fails to reflect any business or economic need for Canteen Service to make the location commission payments in question, and in light of the fact that Canteen Service was already making payments directly to LOF Glass and Toledo Scale, we know of none. Lacking in any meaningful business purpose we fail to see how the payment of such obviously unnecessary amounts could be "appropriate and helpful" for the development of Canteen Service's business. Accordingly we hold that as to the location commissions paid by Canteen Service to Gladco on the sales at LOF Glass and Toledo Scale for the year in question, petitioners are not entitled to a business expense deduction under section 162(a).

There remains for our determination the correctness of respondent's partial disallowance with respect to location commissions made by Canteen Service to Gladco on sales other than at LOF Glass and Toledo Scale, for the period October 1, 1960, through February 20, 1961, and with respect to location commissions made by South-

eastern to Gladco for the same period.[17] Respondent has disallowed only so much of the foregoing location commissions as exceeded the commissions computed pursuant to the rates in effect under the agreement between Canteen Service and Gladco, dated May 10, 1946. Thus, for the period October 1, 1960, through February 20, 1961, respondent disallowed only $4,659.10 out of $25,999.22 claimed by Canteen Service and disallowed $1,593.84 out of $3,558.36 claimed by Southeastern. Since respondent has allowed petitioners' claimed location commissions, although at the lower rates in effect prior to the 1961 agreements, the only question presented is whether respondent correctly disallowed the retroactive increases required by the 1961 agreements.

Petitioners contend that the location commissions were made retroactive to October 1, 1960, because that was the date, originally contemplated by ABC and Virgil in their agreement of June 30, 1960, when the exchange of Virgil's 15 companies was to be made in return for ABC stock. This fact is apparently relied upon by petitioners to justify making the commission payments retroactive to October 1, 1960. Even conceding that the October 1 date was set for that purpose, which the record does not necessarily support, we think petitioners' position is irrelevant with regard to the payment of location commissions by Canteen Service and Southeastern inasmuch as the limited question for our determination is whether the retroactive payments constituted ordinary and necessary business expenses to petitioners. Thus, while the October 1 date

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[17] Except for Canteen Service's commission payments computed upon sales to LOF Glass and Toledo Scale, respondent allowed all location commissions claimed by petitioners for the period February 21, 1961, through September 30, 1961, at the increased rates contained in the 1961 agreements between petitioners and Gladco.

may have been required in order for Virgil to consummate his deal with ABC, we find no valid business reason in the record for petitioners to retroactively pay increased location commissions for more than 4 months. The record is devoid of any meaningful economic benefit flowing to petitioners for such payments, and consistent with our prior determination, *supra*, we think the retroactively increased rates imposed upon petitioners under their 1961 agreements with Gladco merely constituted a necessary concession on Virgil's part, in order to consummate his personal deal with ABC, irrespective of whether such a result proved "appropriate and helpful" for the development of petitioners' business. Accordingly we sustain, under section 162(a), respondent's disallowance of that portion of petitioners' claimed location commissions computed under the retroactive provisions of their 1961 agreements with Gladco.

ISSUE 3. SURTAX EXEMPTIONS.

Respondent has determined that Southeastern was not entitled to a surtax exemption for its fiscal years ended October 3, 1959, October 1, 1960, and September 30, 1961. In his deficiency notice, dated June 19, 1964, respondent assigned as his reason for such disallowance, the following:

> In your income tax returns for the above taxable years, you claimed a surtax exemption. It is held that pursuant to Section 1551 and/or Section 269 of the Internal Revenue Code of 1954, no such surtax exemption is allowable.

Section 1551 of the Code[18] provides, in pertinent part,

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[18] SEC. 1551. DISALLOWANCE OF SURTAX EXEMPTION AND ACCUMULATED EARNINGS CREDIT.

If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corpora-

(*Continued on following page*)

that if a corporation transfers all or part of its property (other than money) to another corporation which was either created for the purpose of acquiring such property or was not actively engaged in business at the time of such acquisition, and after such transfer the transferor corporation or its stockholders are in control of the transferee corporation, then the transferee corporation shall not be allowed the $25,000 surtax exemption unless it establishes by a clear preponderance of the evidence that the securing of such exemption was not a major purpose of the transfer. In order that Southeastern's surtax exemption be denied under section 1551, respondent recognizes that there must have been a "transfer of property" from another corporation to Southeastern at the time of its incorporation. Respondent contends that consistent with

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(*Continued from preceding page*)

tion which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 269 (b)) be allowed either the $25,000 exemption from surtax provided in section 11(c) or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535 (c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For purposes of this section, control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining the ownership of stock for the purpose of this section, the ownership of stock shall be determined in accordance with the provisions of section 544, except that constructive ownership under section 544 (a) (2) shall be determined only with respect to the individual's spouse and minor children. The provisions of section 269 (b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section.

the statutory requirement under section 1551, Canteen Service transferred its eight "Canteen" locations at the Revco Manufacturing Co., in Deerfield, Michigan to Southeastern at a time when Southeastern was not yet actively engaged in business.

While it is true that Southeastern, upon its incorporation in 1956, began operating the eight "Canteens" formerly operated by Canteen Service, that fact does not satisfy the statutory transfer requirement inasmuch as there has been no showing that the "Canteens" transferred to Southeastern were in any way owned by Canteen Service. To the contrary, Automatic owned the vending equipment used at the Revco locations and through its franchise, Automatic determined who would operate such "Canteens." The record clearly reflects the fact that Southeastern operated the "Canteens" at Revco under such a franchise agreement with Automatic. In light of this fact we do not think Canteen Service ever possessed such a property right in the eight "Canteens" which could have been the subject of transfer to Southeastern. That being the case, the transfer requirement of section 1551 has not been met and Southeastern may not be denied its surtax exemption under that statutory provision.

Respondent contends, however, that Southeastern's surtax exemption should also be denied under section 269 of the Code.[19] The pertinent provisions of that section

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[19] SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another

(Continued on following page)

provide that where any person or persons acquire control of a corporation for the "principal purpose" of evading or avoiding Federal income tax by securing the benefit of a deduction or other allowance which such person would not otherwise enjoy, the Secretary may disallow such deduction or other allowance. Upon a consideration of the entire record, we think the facts require us to hold that Southeastern was incorporated in 1956 for the princi-

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(Continued from preceding page)

"corporation, not controlled, directly, or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or His Delegate To Allow Deduction, Etc., in Part.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

pal purpose of avoiding Federal income taxes, although in arriving at our determination we recognize that the creation of Southeastern may also have served legitimate business purposes.

In an attempt to convince us that tax avoidance was not the principal purpose of incorporating Southeastern, petitioners rely heavily on Virgil's self-serving testimony which was to the effect that his company's projected expansion into Michigan required the creation of a "local identity" or "Michigan image." We are asked to accord great weight to this conclusion because of the fact that Virgil "has been experienced and successful in business." While the successful expansion of Virgil's vending business in Michigan may have necessitated the use of a "Michigan" corporation, the record does not support such a conclusion.

In 1953 Canteen Service, an Ohio corporation, qualified to do business in Michigan and received authorization from Automatic to operate "Canteens" at Revco's plant in Deerfield, Michigan. Canteen Service continued to operate those "Canteens" until Southeastern began its Michigan operations in 1956. Virgil's testimony, as well as petitioners' briefs, goes to great length to show that after Southeastern began its operations it established headquarters in Michigan, hired two men residing in Michigan to supervise its operations, opened bank accounts in Michigan, and established warehouse and refrigeration facilities in Michigan. While we do not question these facts, the weakness in petitioners' position is that there is no reason shown, and we know of none, which would have forbidden Canteen Service from adopting the same Michigan contacts. Of additional significance is the fact that although Virgil's testimony stressed the importance of a Michigan image, the franchise agreement under which Southeastern obtained virtually all its vending machines,

specifically prohibited Southeastern from using its name on the vending machines in a manner which would give the appearance that Southeastern was the owner of the machines. Thus, at the time of Southeastern's incorporation, both Canteen Service and Southeastern were owned by the same individuals (Virgil and Handwork) in the same percentages (75 and 25, respectively); Southeastern took over virtually the same Michigan business that Canteen Service gave up; both businesses were based upon a franchise with Automatic which provided the necessary "Canteens" for an agreed rental; both corporations were on the 13-period system of tabulating income and expenses, using the same fiscal year; and both corporations used the same street address in Toledo, Ohio, to designate their corporate address on their Federal income tax returns. It is in no way apparent from the record why Canteen Service could not have continued to operate and expand the Michigan business. Virgil's conclusory statement regarding the need for a Michigan image finds no support in the record. Considering his business experience and success, as vouched for by petitioners and revealed by the number and extent of his food service corporations, we think it a fair assumption that he was well aware of the Federal income tax advantages to be gained by the addition of yet another corporation to his already extensive operations. Considering the totality of facts bearing upon this issue, we are satisfied that petitioners have failed to show that the acquisition of an additional surtax exemption was not the "principal purpose" of incorporating Southeastern in 1956. Accordingly we must sustain respondent's disallowance of Southeastern's surtax exemption for the years at issue, pursuant to section 269 of the Code.

Decisions will be entered for the respondent.

APPENDIX C.

STATUTE INVOLVED.

§ 162(a) of the Internal Revenue Code of 1954 states in pertinent parts:

> "Sec. 162(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * *.
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * *"